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2005 ANNUAL REPORT TO CONGRESS

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CRIMINAL INVESTIGATION  
REFUND FREEZE STUDY

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VOLUME 2

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## TABLE OF CONTENTS

<b>EXECUTIVE SUMMARY</b> .....	1
Introduction .....	1
Background .....	1
Methodology .....	1
Findings .....	2
Recommendations .....	3
<i>Review marginal revenue</i> .....	3
<i>Consider alternative treatments</i> .....	3
<i>Notify taxpayers of frozen refunds</i> .....	4
<i>Rank suspected fraudulent refund returns</i> .....	4
<i>Review practice of freezing refunds on returns filed</i> <i>for tax years subsequent to the fraudulent return</i> .....	4
<i>Review the 180 day period during which other</i> <i>IRS organizations cannot assist the taxpayer</i> .....	4
<b>INTRODUCTION</b> .....	5
<b>BACKGROUND</b> .....	5
<b>METHODOLOGY</b> .....	7
Sample Selection Process .....	7
Data Collection and Analysis .....	8
Limitations .....	9
<b>OBJECTIVES</b> .....	10
<b>FINDINGS</b> .....	10
Objective I: Describe the characteristics of taxpayers coming to TAS because their refunds were frozen by CI .....	10
Objective II: Determine the number of taxpayer refunds held where the CI refund freeze was effective (in cases of fraud) or ineffective (in cases where fraud was not substantiated and the refund was subsequently released) .....	12
Objective III: Determine the length of the CI freeze that holds taxpayer refunds .....	15
Objective IV: Determine the likelihood that taxpayers will become repeat filers of fraudulent returns .....	16
Objective V: Compute the amount of revenue actually protected and compare to interest that is paid on subsequently released refunds .....	17
Objective VI: Determine if CI cases are correctly coded on TAMIS .....	20

## CONTENTS

<b>CONCLUSIONS</b> .....	27
I. Describe the characteristics of taxpayers coming to TAS because their refunds were frozen by CI.....	21
II. Describe the number of taxpayer refunds held effectively (in cases of fraud) or ineffectively (in cases where fraud was not substantiated).....	22
III. Determine the length of the CI freeze that holds taxpayer refunds .....	23
IV. Determine the likelihood that taxpayers will become repeat filers of fraudulent returns .....	23
V. Compute the amount of revenue actually protected and compare to interest that is paid on subsequently released refunds .....	23
VI. Determine if TAMIS is correctly coding CI cases.....	24
 <b>RECOMMENDATIONS</b> .....	25
 <b>APPENDICES</b> .....	27
Criminal Fraud Penalties .....	27
CI Data Collection Instrument (DCI) .....	31
TAS Data Collection Instrument (DCI) .....	33

## TABLE OF FIGURES

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Figure 1:	TAS Receipts of CI Cases . . . . .	5
Figure 2:	Receipt of CI Cases in TAS. . . . .	11
Figure 3:	Adjusted Gross Income Broken Out By All Cases Versus Cases With EITC Only . . . . .	11
Figure 4:	Median Refund Returned After IRS Processing Versus Median AGI. . . . .	12
Figure 5:	Presence of Fraud . . . . .	13
Figure 6:	Average Length of Time CI Freezes Refunds. . . . .	15
Figure 7:	Incidence of Prior Year Fraud . . . . .	17
Figure 8:	Net Revenue Protected (all sample cases) . . . . .	18
Figure 9:	Net Revenue Protected (all cases that have been decided). . . . .	19
Figure 10:	Determination of Cases Where Manual Review Indicates Fraud. . . . .	19
Figure 11:	Analysis of TAMIS Coding. . . . .	20

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### INTRODUCTION

The Taxpayer Advocate Service (TAS) conducted a study, in collaboration with Criminal Investigation (CI), of TAS cases involving tax refunds frozen by CI. The study period included fiscal year (FY) 2004 and the first half of FY 2005. This study serves as Volume II of the National Taxpayer Advocate's 2005 Annual Report to Congress (ARC) and documents findings that are referenced in the Most Serious Problem, Criminal Investigation Refund Freezes, in Volume I of the ARC.

### BACKGROUND

From fiscal years 2002-2005, the number of cases referred to TAS as a result of CI actions to deter fraud grew by over 400 percent and became the largest single component of TAS inventory. TAS has raised the concern that the high percentage of outcomes where TAS obtains the relief sought by the taxpayer suggests problems with the CI case selection process. A review of TAS case closures for FY 2005 through March 31, 2005, reflects that 53 percent of the cases were closed with the taxpayers receiving full relief.<sup>1</sup>

In contrast, CI statistics show a much higher rate of fraud among cases referred to TAS. To resolve this discrepancy, CI and TAS agreed to collaborate in a study of a representative sample of recently closed TAS cases involving refunds frozen by CI. In addition to reconciling differences between the TAS and CI reported outcomes, TAS also recognized that the study presented an opportunity to examine CI fraud detection and prevention procedures and to possibly identify improvements.

### METHODOLOGY

TAS Research developed a sample of CI refund freeze cases that were closed by TAS during fiscal 2004 and the first half of FY 2005 (period ending March 31, 2005). An approximately equal number of cases was selected for each fiscal year. The sample cases were randomly selected using the Taxpayer Advocate Management Information System (TAMIS) Quality Review random selection application.<sup>2</sup>

TAS Research chose a sample size of 500 to ensure that a sufficient number of cases would be available to allow study findings to be projected to the population of TAS CI refund freeze cases closed during the study period with a margin of error no greater than +/- five percent at the 95 percent confidence level.

TAS Research used Master File data to conduct the vast majority of the analyses contained in this report, since reliance on Master File data minimizes data transcription

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<sup>1</sup> IRS Business Performance Management System, March 2005.

<sup>2</sup> TAS's database, TAMIS, is dedicated to the recordation, control, and processing of TAS taxpayer cases and to the analysis of core tax issues, laws, policies, and internal IRS functional processes that are the sources of significant taxpayer hardship and other critical problems. Cases are classified by primary core issue codes (PCIs) identifying the main concern or issue at question. CI cases are designated with PCI 950.

errors inherent in the manual data collection process.<sup>3</sup> The analyses use transaction code data indicating the issuance or reversal of refunds to determine whether a case contained indicia of fraud. By comparing the refund actually issued to the refund claimed on the return, the analyses clearly show whether the claimed refund was received. The definitions for determining whether indicia of fraud existed follow:

- ◆ **No Fraud:** *Fraud is considered to be **not** present, if the taxpayer received the full refund after the tax module had been placed in freeze status. In all instances, the refund issued must have equaled or exceeded the amount claimed on the original return.*
- ◆ **Fraud:** *Fraud is considered present if the taxpayer's refund was reduced or reversed while the module was in freeze status. Since CI sometimes identifies fraud after the refund is released, we also considered fraud to be present if the refund was released and a freeze was later put on the module during the same calendar year. **Note that this is a very broad definition. Although some or all of the refund was disallowed, we did not determine the reason for disallowance.***
- ◆ **Undecided:** *TAS Research found no indication that the refund claimed on the return was reduced or reversed, but no refund had been issued. These cases appeared not to have been worked to completion.*

The definition TAS Research used to determine the presence of fraud is very broad. In this study, any reduction in the refund originally claimed by the taxpayer is considered an indication of fraud. It is likely that in some cases, the adjustments to the refund amount resulted from honest taxpayer error.

## FINDINGS

Principal study findings included:

- ◆ Most of the returns in the sample were in the lower income strata, and on the average the frozen refund represented over 25 percent of the taxpayers' yearly incomes. About 75 percent of the taxpayers claimed the Earned Income Tax Credit (EITC).
- ◆ We found that nearly two-thirds (66 percent) of the decided cases in our sample were not fraudulent, and that over 80 percent received at least a partial refund.
- ◆ Taxpayers had to wait about nine months, on average, to receive their refunds. The delay is longer for some, as one out of every five taxpayers in this group did not receive their refund for over a year.
- ◆ Over one half of the taxpayers in our sample had an adjusted gross income (AGI)

<sup>3</sup> The accuracy of Master File data is improved through the use of programs that check for math and transcription errors. Although the data collected from the Data Collection Instrument (DCI) was checked for errors, it is possible that some errors were committed when the data was recorded.



below \$13,000 and many ultimately received the EITC.<sup>4</sup> As stated above, on average the frozen refund represented over 25 percent of the taxpayers' yearly income (and much more for those with lower incomes). These findings suggest that the extended delays often impose a severe economic hardship on taxpayers who ultimately received refunds.

- ◆ In almost 18 percent of the sample cases, CI prohibited TAS from contacting the taxpayer in response to the taxpayer's inquiry about the frozen refund. In over 20 percent of these cases, the taxpayer ultimately received a full refund. It is possible that more taxpayers would have received a full refund if TAS had been given permission to contact them.
- ◆ Only six percent of taxpayers in the sample were found to have repeat indicia of fraudulent actions.<sup>5</sup> In over 85 percent of these cases, the CI identification of fraud was too late to stop issuance of the refund in the initial year. This suggests that CI efforts to prevent future fraud are effective if the compliance action materially affects the taxpayer. This finding also suggests that CI's current policy of freezing future refunds for a certain number of years may be overly restrictive.
- ◆ At most, after considering interest paid on delayed refunds, CI protected less than 20 percent of the refund amounts originally frozen in the sample.<sup>6</sup> The amount of interest paid to taxpayers who ultimately received their refunds was more than 15 percent of the amount protected. Depending on the outcome of one large undecided case, the amount of revenue protected may actually be negative.

## RECOMMENDATIONS

### *Review marginal revenue*

TAS recommends that CI and the Business Operating Divisions determine the marginal revenue gained by working different categories of returns identified as fraudulent. The marginal revenue gained by working these cases can then be compared to the yield gained in Examination by working non-fraudulent cases to see if the expenditure of resources on some of these cases is merited.

### *Consider alternative treatments*

CI should consider alternative treatments for addressing noncompliance among taxpayers suspected of fraud. These alternative treatments may encompass methods similar to those used currently by Examination. For example, a "soft" letter may be an effective tool for addressing noncompliance among taxpayers suspected of fraud, where the dollar

<sup>4</sup> The Earned Income Tax Credit (EITC) is the nation's largest need-based anti-poverty program. Frank Sammartino, Eric Toder and Elaine Maag, *Providing Federal Assistance for Low-Income Families Through the Tax System: A Primer*, The Urban-Brookings Tax Policy Center 8 (July 2002) at <http://www.urban.org/uploaded-pdf/410526.pdf>.

<sup>5</sup> There were 29 such cases out of 454 cases.

<sup>6</sup> 18.9 percent. See Figure 8 (\$574,960 / \$3,035,710).

## SUMMARY

amount of the alleged noncompliance is relatively small or there is evidence of a “facilitator” (e.g., a preparer).

*Notify taxpayers of frozen refunds*

CI should notify taxpayers soon after their refunds are frozen that their refund claims are being reviewed and will not be released until a determination is made. Notification should include complete coverage of taxpayer rights (e.g., their right to file suit in Tax Court to claim their refunds) and a list of resources available to taxpayers for assistance (e.g., TAS and the Low Income Taxpayer Clinics).

*Rank suspected fraudulent refund returns*

CI should consider using its scoring algorithm to rank cases suspected of fraud. This would enable CI to freeze only those cases that have the highest scores and greatest risk of fraud, and for which the IRS can ensure timely processing.

*Review practice of freezing refunds on returns filed for tax years subsequent to the fraudulent return*

CI should review its policy of freezing refunds for a certain number of subsequent tax years after fraud is initially detected. Study findings show that the likelihood of taxpayers repeating fraudulent behavior is very small. Further, the resources devoted to these subsequent periods could be better utilized in working new inventory more expeditiously. Subsequent returns will also be reviewed automatically by CI’s ongoing fraud detection procedures. TAS is concerned that this practice could potentially harm taxpayers who qualify for refunds by discouraging them from filing (e.g., taxpayers who qualify for the EITC).

*Review the 180 day period during which other IRS organizations cannot assist the taxpayer*

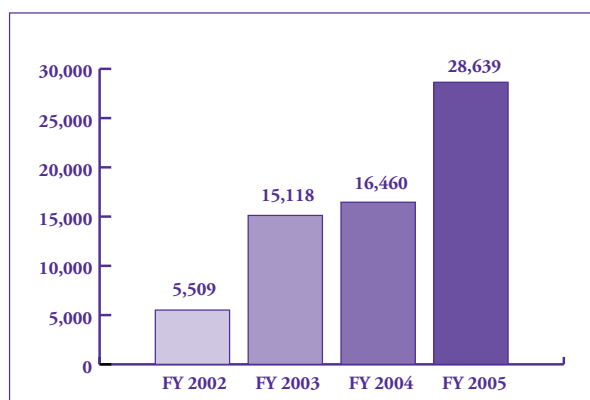
CI should consider shortening this period to 60 or 90 days from the date the refund freeze begins. This would help alleviate taxpayer burden by enabling TAS to assist taxpayers much sooner. TAS also recommends that CI develop expedited procedures for certain circumstances, including economic hardship, EITC, and identity theft cases.

# CRIMINAL INVESTIGATION REFUND FREEZE STUDY

## INTRODUCTION

The Taxpayer Advocate Service (TAS) routinely reviews its inventory to detect issues affecting taxpayers that are indicative of IRS systemic problems. In this regard, TAS has noted that the volume of Criminal Investigation (CI) cases among TAS receipts has increased dramatically in the last four years. These cases are now the number one source of taxpayer cases coming to TAS. Figure 1 shows the growth in these cases. These cases predominantly involve taxpayers whose refunds have been frozen by CI, although taxpayers may not be aware of CI's involvement in the case.<sup>7</sup>

**FIGURE 1: TAS RECEIPTS OF CI CASES**<sup>8</sup>



To address this rapidly expanding component of its inventory, TAS conducted a study, in collaboration with the Criminal Investigation Division (CI), of TAS cases involving tax refunds frozen by CI. CI freezes refunds it identifies as potentially fraudulent to prevent their issuance. The principal goals of this study were to reconcile differences between TAS and CI statistics concerning the rate of fraud among cases coming to TAS, and to identify possible improvements in CI fraud detection and prevention procedures.

## BACKGROUND

CI has ten Fraud Detection Centers (FDCs) charged with identifying fraudulent claims for income tax refunds and preventing their issuance. When the FDCs identify cases as having certain indicia of fraud, they freeze the taxpayer accounts causing extensive delays in the issuance of refunds.

CI manages several programs to detect tax fraud, including the Questionable Refund Program (QRP) and the Return Preparer Program (RPP). Fraud Detection Centers implement these programs to freeze accounts that meet certain criteria, thereby stopping

<sup>7</sup> When CI places a Z Freeze on a tax module indicating that CI believes the refund claim is fraudulent, TAS is precluded from informing a taxpayer of CI's involvement in a case. IRM § 13.1.10.9.

<sup>8</sup> Figure 1 is based only on the TAS primary issue code. Including secondary issue code case counts, the FY 2005 count of CI cases received into TAS inventory is 31,627.

## FREEZE STUDY

VOLUME  
TWO

all processing related to the account, including the issuance of refunds.<sup>9</sup> CI also freezes other taxpayer accounts during its investigation of return preparers.

CI initiates most refund freezes under the QRP program. QRP uses a scoring algorithm to analyze the tax returns submitted by taxpayers seeking refunds to identify potentially fraudulent returns. Although most QRP schemes are detected during the scoring process, some are identified through communications from electronic return originators, financial institutions, return preparers, and concerned citizens.<sup>10</sup>

A contractor developed the QRP scoring algorithm by using data mining software<sup>11</sup> to analyze fraudulent schemes detected in prior year returns. When the score assigned to a return exceeds a predetermined threshold, the return is selected for further review.

To prevent questionable refunds from being automatically issued, the selected returns are resequenced. Resequencing removes returns from processing until the next refund processing cycle. Since each refund processing cycle is one week, the resequencing step gives CI one week to analyze the refund claim further to determine whether a freeze should be placed on the account. In processing year 2004, CI resequenced over one million refund claims.<sup>12</sup>

During this one week period, CI manually reviews returns to determine which should be further verified. The verification process is used to address the most prevalent illegal refund schemes, including:

- ◆ Falsifying Form W-2 withholding to obtain refunds.
- ◆ Fraudulently misstating income to obtain a refund from the EITC.

Due to the high volume of cases sent through the verification process, there is often insufficient time within the allotted week to complete all cases selected for verification. Cases still requiring verification are designated with a P freeze, which puts them in temporary hold status. CI does not know how many refund claims are designated with a P freeze annually.

After verification, if fraud was not detected, the IRS releases the refund to the taxpayer. If CI believes the refund claim is fraudulent, it puts the account in Z freeze status.<sup>13</sup> This prevents a refund from being issued unless CI subsequently reverses or overrides

<sup>9</sup> IRM § 9.8.1.3.1.4 assigning freeze code functions to FDCs.

<sup>10</sup> IRS Overview, Questionable Refund Program, at <http://www.irs.gov/compliance/enforcement/article/0,,id=117528,00.html>.

<sup>11</sup> Software that develops algorithms by detecting trends and patterns in data.

<sup>12</sup> 1,051,154. The “IRS Overview, Questionable Refund Program, at <http://www.irs.gov/compliance/enforcement/article/0,,id=117528,00.html>. The “processing year” is the calendar year in which a taxpayer files his or her return.

<sup>13</sup> In FY 2003, CI verified 130,579 cases and identified 96,953, or 74 percent as fraudulent. In FY 2004, CI verified 179,138 cases and identified 118,075, or 66 percent, as fraudulent.

the Z freeze. All cases with a Z freeze that involve refundable credits like the EITC are then referred to Examination for final resolution. If Examination determines that the taxpayer is due a refund, CI must approve this determination and reverse or override the Z freeze so that the refund can be released to the taxpayer. Once a Z freeze has been placed on a taxpayer's account, returns for subsequent tax years will automatically go directly into Z freeze status and must be reviewed by CI.

TAS has raised the concern that the high percentage of outcomes where TAS obtains the relief sought by the taxpayer suggests problems with the CI case selection process. A review of TAS case closures for FY 2005 through March 31, 2005, reflects that 53 percent of the cases are closed with the taxpayers receiving full relief.<sup>14</sup>

In contrast, CI statistics show a much higher rate of fraud among cases referred to TAS. To resolve this discrepancy, CI and TAS agreed to collaborate in a study of a representative sample of recently closed TAS CI refund freeze cases. TAS also recognized that the study presented an opportunity to examine CI fraud detection and prevention procedures and to possibly identify improvements.

## METHODOLOGY

### Sample Selection Process

This study was conducted on a sample of TAS cases involving tax refunds frozen by CI and closed from the beginning of FY 2004 through the first half of FY 2005. Slightly more than half of the sample was selected from FY 2004, and the remaining cases were selected from FY 2005.<sup>15</sup> The sample cases were randomly selected using the Taxpayer Advocate Management Information System (TAMIS) Quality Review random selection application.<sup>16</sup>

TAS Research chose a sample size of 500 to ensure that a sufficient number of cases would be available to allow study findings to be projected to the population of TAS CI refund freeze cases closed during the study period with a margin of error no greater than +/- 5 percent at the 95 percent confidence level. Ultimately, 27 cases were removed from the sample because they did not fall within the sample parameters. For example, some of the cases did not involve frozen refunds, and others were removed because insufficient information was available to analyze them. After dropping these cases, the final sample consisted of 473 cases.

<sup>14</sup> TAMIS data as recorded in IRS Business Performance Management System, March 2005.

<sup>15</sup> TAS Research selected nearly as many cases from the first half of FY2005 as from all of 2004, to assure that the sample reflected current trends in CI processing and procedures.

<sup>16</sup> TAS' database, TAMIS, is dedicated to the recordation, control and processing of TAS taxpayer cases and to the analysis of core tax issues, laws, policies and internal IRS functional processes that are the sources of significant taxpayer hardship and other critical problems. Cases are classified by primary core issue codes (PCIs) identifying the main concern or issue at question. CI cases are designated with PCI 950.

### Data Collection and Analysis

TAS, with input from CI, developed two comprehensive Data Collection Instruments (DCIs) to capture the relevant data.<sup>17</sup> The TAS and CI DCIs focused on different characteristics of the sample cases. The DCIs were designed to capture information from the sample case files that could be used to supplement the data available from Master File.

There was significant overlap of the data elements contained on the CI and TAS DCIs to allow for cross-checks on critical issues. Both DCIs contained information on the case outcome, the presence or absence of indicia of fraud, and time frames for case resolution. In addition, the CI DCI contained information on interaction with TAS, such as Operations Assistance Request (OAR) receipts.<sup>18</sup> The TAS DCI contained information on the presence or absence of the EITC, taxpayer AGI, and TAMIS database information on OAR issuance.

TAS collected data at the IRS's Austin Campus, relying on a combination of IDRS and TAMIS data to complete the DCIs. CI sent its DCIs to the FDCs for completion. Each sample case was reviewed by the FDC responsible for working the case originally.

Coincident with the manual case reviews conducted by TAS and CI, TAS Research obtained data on the sample cases from the Compliance Research Information Tracking System (CRITS). CRITS provides access to requested data elements available on the online master file for the list of Taxpayer Identification Numbers (TINs) supplied with the CRITS request. TAS Research used CRITS data to verify, to the extent possible, the data collected and analyses conducted during the manual review. TAS shared the CRITS data and all analyses conducted on both the DCI information and the CRITS data with CI for verification.

TAS Research used Master File data to conduct the vast majority of the analyses contained in this report, since reliance on Master File data minimizes data transcription errors inherent in the manual data collection process.<sup>19</sup> The analyses use transaction code data indicating the issuance or reversal of refunds to determine whether a case contained indicia of fraud. By comparing the refund actually issued to the refund claimed on the return, the analysis clearly shows whether the claimed refund was received. A separate set of transaction codes was utilized to determine when CI involvement in the case began. The definitions for determining whether indicia of fraud existed follow:

- ◆ **No Fraud:** *Fraud is considered to be **not** present if the taxpayer received the full refund after the tax module had been placed in freeze status. In all instances, the refund issued must have equaled or exceeded the amount claimed on the original return.*

<sup>17</sup> See appendices II and III.

<sup>18</sup> TAS does not have the statutory or delegated authority to release refunds frozen by CI and must therefore forward the case to CI for a determination on the release of the refund.

<sup>19</sup> The accuracy of Master File data is improved through the use of programs that check for math and transcription errors. Although the data collected from the DCI was checked for errors, it is possible that some data errors were committed when the data was recorded.

- ◆ **Fraud:** *Fraud is considered present if the taxpayer's refund was reduced or reversed while the module was in freeze status. Since CI sometimes identifies fraud after the refund is released, we also considered fraud to be present if the refund was released and a freeze was later put on the module during the same calendar year. Note that this is a very broad definition. Although some or all of the refund was disallowed, we did not determine the reason for disallowance.*
- ◆ **Undecided:** *TAS Research found no indication that the refund claimed on the return was reduced or reversed, but no refund had been issued. These cases appeared not to have been worked to completion.*

As previously noted, the presence or absence of indicia of fraud was based on Master File data, not on the TAS coding of the case resolution. Most of the analyses in this report are based on the sample year. Some analyses, however, were performed on tax return filings from Tax Years 2001 through 2004. TAS Research used these multi-year analyses to determine whether taxpayers were likely to repeat activities indicative of fraud, as well as to examine burden experienced by taxpayers whose refunds were frozen across multiple years. Data was not available to review return filings for the sample taxpayers prior to Tax Year 2001.

### Limitations

The sample data for this project is only representative of taxpayers with refunds frozen by CI who seek assistance from TAS. While the sample results may have implications for the population of refunds frozen by CI, the results cannot be explicitly attributed to the population of refunds frozen by CI.

Additionally, the definitions TAS Research used to determine the presence of fraud are very broad. In this study, any reduction in the refund originally claimed by the taxpayer is considered as an indication of fraud. It is likely that in some cases the adjustments to the refund amount resulted from honest taxpayer error. See Appendix I for a discussion of the legal basis for fraud determinations.

Another limitation is that the refund amount was based solely on the amount actually received by the taxpayer. No data was obtained to determine those instances in which the originally claimed refund was awarded but the amount actually received by the taxpayer was reduced because of an offset of part or all of the refund to another tax or obligation collected by the IRS. It is likely that some taxpayers in the sample who were classified as fraudulent actually had their refunds reduced by offset and were not fraudulent.



## OBJECTIVES

The principal objectives of the study were to:

- I. Describe the characteristics of taxpayers coming to TAS because their refunds were frozen by CI.
- II. Determine the number of taxpayer refunds held where the CI refund freeze was effective (in cases of fraud) or ineffective (in cases where fraud was not substantiated and the refund was subsequently released).
- III. Determine the length of the CI freeze that holds taxpayer refunds.
- IV. Determine the likelihood that taxpayers will become repeat filers of fraudulent returns.
- V. Compute the amount of revenue actually protected and compare to interest that is paid on subsequently released refunds.
- VI. Determine if TAMIS is correctly coding CI issue cases.

## FINDINGS

The findings are ordered by objective, and a restatement of each objective precedes a brief summary of the key findings relevant to this objective (see italicized text). The research issues pertinent to the objective are then listed, followed by a more detailed review of the findings.

**Objective I:** Describe the characteristics of taxpayers coming to TAS because their refunds were frozen by CI.

*When considering all 473 current year returns in the sample, half of all taxpayers had adjusted gross incomes below \$12,850, with 80 percent of all sample returns having an adjusted gross income less than \$23,000. Nearly three quarters (74 percent) of the sample returns claimed the Earned Income Tax Credit (EITC), and a majority of these taxpayers ultimately received the EITC.*

All of the 473 sample cases were analyzed to determine the following characteristics<sup>20</sup> regarding these returns:

- ◆ Referral of the case to TAS.
- ◆ Return characteristics including:
  - ◆ The income of taxpayers included in the sample.
  - ◆ The number claiming EITC.
  - ◆ The average size of the refund frozen by CI.
  - ◆ The filing status claimed on the return.

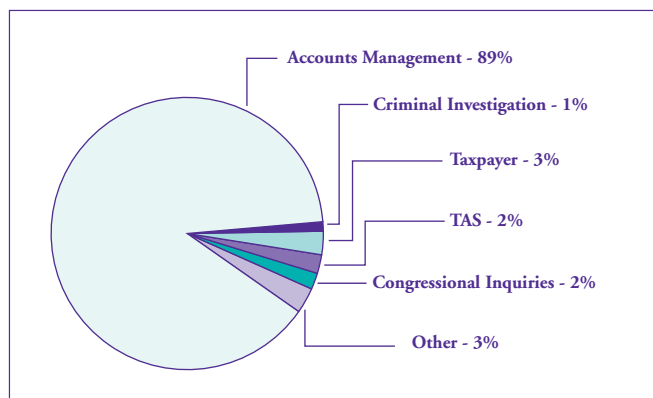
<sup>20</sup> Information obtained from the DCI was also used to determine what function referred the case to TAS. Master File data was utilized to describe the return characteristics.



### TAS Referrals

Eighty-nine percent of the sample cases entered TAS inventory through an Accounts Management (AM) referral. Figure 2 shows that no other source accounts for a significant volume of these cases in the TAS inventory.

**FIGURE 2: RECEIPT OF CI CASES IN TAS**



### Return Characteristics

An examination of the income of the sample cases indicates that most taxpayers who seek TAS assistance to resolve refunds frozen by CI are in the lower strata of income. The distribution of AGI for all 473 taxpayers in our sample is shown in Figure 3 as the line labeled “All Cases.”

**FIGURE 3: ADJUSTED GROSS INCOME BROKEN OUT BY ALL CASES VERSUS CASES WITH EITC ONLY**

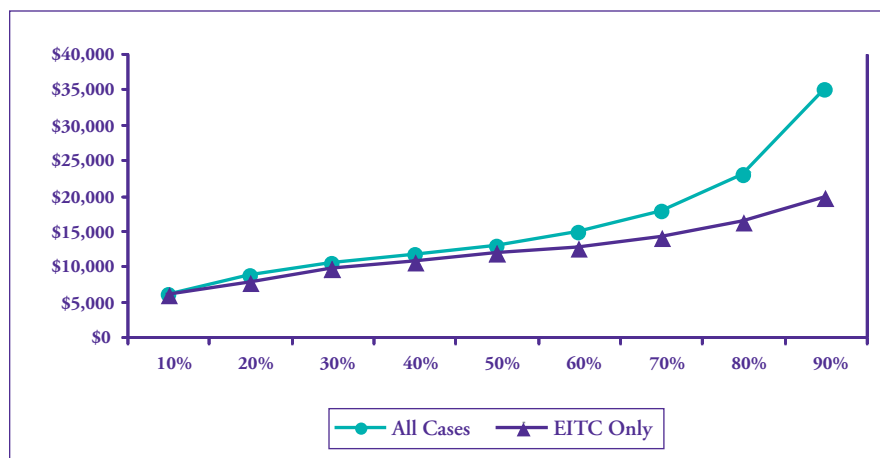


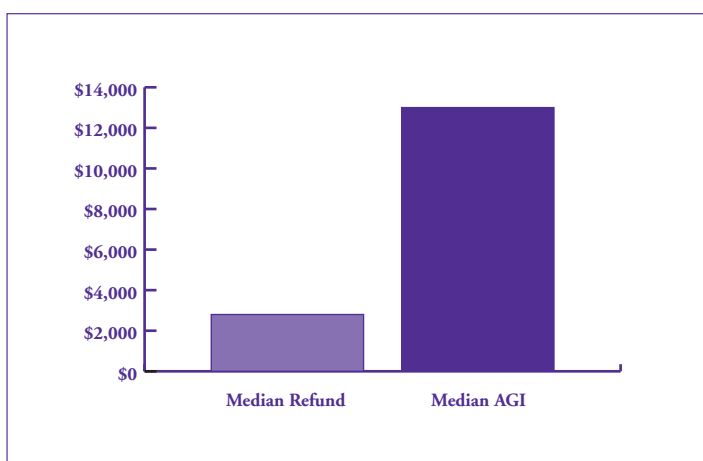
Figure 3 illustrates that half of all taxpayers in our sample had income below \$12,850. The distribution of adjusted gross income (AGI) for those taxpayers with the EITC is

shown in Figure 3 as the line labeled “EITC Only.” With respect to the distribution of income across these two groups, taxpayers claiming the EITC have the lower AGI.

Nearly 75 percent of the taxpayers who claimed the EITC were allowed the credit after IRS processing. The average amount of the EITC initially claimed was \$2,853.<sup>21</sup>

Most of the refunds frozen by CI were sizeable, as half of all taxpayers in our sample received a refund of \$3,500 or more.<sup>22</sup> As illustrated in Figure 4, the refund amounted to over 25 percent of the AGI for half of all taxpayers.

**FIGURE 4: MEDIAN REFUND RETURNED AFTER IRS PROCESSING VERSUS MEDIAN AGI**



We also looked at filing status. We found that just over two thirds of all taxpayers in our sample of cases filed as Head of Household, and one-fourth of all taxpayers claimed the single filing status. Accordingly, based on filing status, over 90 percent of the sample taxpayers were the sole providers for their households.

**Objective II:** Determine the number of taxpayer refunds held where the CI refund freeze was effective (in cases of fraud) or ineffective (in cases where fraud was not substantiated and the refund was subsequently released).

*Overall, 56 percent of the sample returns were determined to be without fraud.<sup>23</sup> When removing those sample returns whose outcomes had not been decided (almost 16 percent), the percentage of*

<sup>21</sup> The amount claimed is after IRS programs have corrected math and transcription errors. EITC math error authority also includes some compliance checks to better ensure age, relationship and Social Security Number validity.

<sup>22</sup> The average refund was well over \$6,000.

<sup>23</sup> Sample cases were determined to have no indicia of fraud if an amount equal to or exceeding the frozen refund claimed on the original return was received by the taxpayer. The amount of refund actually received by the taxpayer was determined by netting the Master File transaction codes for refund issuances and reversals. Data on refund offsets was not captured. It is likely that some taxpayers in the sample who were classified as fraudulent actually had their refunds reduced by offset and were not fraudulent.

returns *without* fraud exceeds 66 percent.<sup>24</sup>

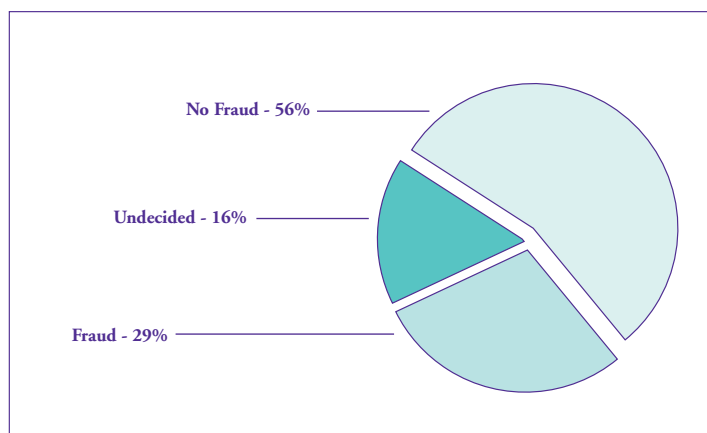
The study addressed the following questions pertinent to this objective:

- ◆ What is the current status of the sample cases in regard to the presence or absence of fraud?
- ◆ What is the current status of the EITC sample cases in regard to the presence or absence of fraud?
- ◆ How many of the sample taxpayers had refunds frozen for at least four consecutive years and received a full refund each year?
- ◆ How many taxpayers have refunds which remain frozen?
- ◆ How many cases contained a CI prohibition that TAS could not respond to the taxpayer's refund inquiry?
- ◆ How many sample cases had their refunds frozen because of stolen identity issues?

### Sample Returns: Indicia of Fraud and Presence of EITC

The majority of sample returns were found to have no indicia of fraud, as shown in Figure 5. The outcome of approximately 16 percent of the sample cases remained undecided. We also found that almost 75 percent of the sample returns had claimed the EITC.

FIGURE 5: PRESENCE OF FRAUD<sup>25</sup>



Removing the undecided cases from the sample, the data indicated that 66 percent of these taxpayers had committed no fraud (263 out of 398 cases). The decided cases were

<sup>24</sup> While 56 percent of the sample cases were without fraud, when applying the weights from the stratified sample, the weighted number of cases without fraud was 55 percent. Accordingly, at the 95 percent confidence level between 51 percent and 59 percent of all taxpayers did not commit fraud. Excluding undecided cases, at the 95 percent confidence level between 62 percent and 70 percent of all taxpayers did not commit fraud.

<sup>25</sup> Total exceeds 100 percent due to rounding.

## FREEZE STUDY

VOLUME  
TWO

split into two groups based on the presence or absence of EITC. Analysis demonstrated that the percentage of fraudulent returns in each group was similar. *Thus, the percentage of taxpayers who commit fraud and lose their EITC refund is neither higher nor lower than the percentage of taxpayers who commit fraud and do not claim the EITC.*<sup>26</sup> Further, we found that over half of the EITC claimants received full refunds. This suggests that in the population of TAS cases, taxpayers claiming EITC are no more likely to commit fraud than taxpayers who did not claim the EITC.

### Multiple Year Frozen Refunds

While most of the analyses for this study focused on the sample tax year, analysis was also completed on the four consecutive tax years from 2001 through 2004. TAS Research conducted this multiple year analysis to explore the effectiveness of CI's policy to freeze refunds for years subsequent to the first incidence of refund fraud, as well as to examine the associated burden on taxpayers who continue to experience these refund freezes.<sup>27</sup> All four of the tax years with available data (2001 through 2004) were analyzed. This analysis showed that 29 percent of the taxpayers in the sample had their refunds frozen for four consecutive years, but ultimately received full refunds in all of these years.

### Additional Modules With Refunds Still Frozen

As previously mentioned, TAS Research analyzed the tax returns filed by taxpayers in the sample for Tax Years 2001 through 2004. In addition to the 75 sample tax periods where a decision on the outcome of the refund had not yet been made, 23 percent of the taxpayers in the sample (108 different taxpayers) had at least one other return with its refund still frozen.<sup>28</sup>

### TAS Prohibited from Contacting Taxpayer

In almost 18 percent of the sample cases, CI prohibited TAS from contacting the taxpayer in response to the taxpayer's inquiry about the frozen refund.<sup>29</sup> In over 20 percent of these cases, the taxpayer ultimately received a full refund. It is possible that more taxpayers would have received a full refund if TAS had been given permission to contact the taxpayer.

<sup>26</sup> Chi square analysis showed no significant difference between the EITC and non-EITC return fraud rates.

<sup>27</sup> The additional frozen tax years were determined to be those with a claimed refund (IRS determined amount after return processing) with no indication of the issuance of a refund based on the Master File transactions codes and with no other transactions which would reduce the claimed refund (*i.e.*, audit referral, or audit adjustment of tax, EITC, or withholding).

<sup>28</sup> 118 different tax refunds were frozen (nine prior to sample year and 109 subsequent to sample year).

<sup>29</sup> CI is concerned that administrative contact of a taxpayer under CI investigation could adversely impact possible subsequent criminal prosecution of the taxpayer.

**Objective III: Determine the length of the CI freeze that holds taxpayer refunds.**

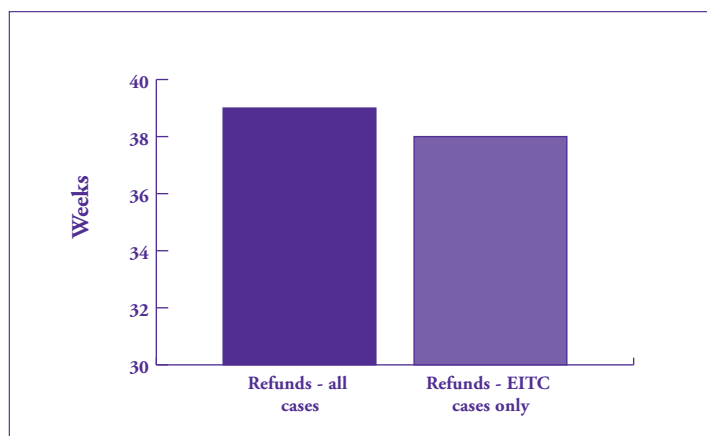
*Over two-thirds (67 percent) of all sample cases resulted in the issuance of at least a partial refund to taxpayers. When considering only the decided cases, over 80 percent of the sample taxpayers received some or all of their originally claimed refunds. The median wait for these refunds was nearly nine months (over 37 weeks). Over 70 percent of these taxpayers were also entitled to EITC.*

The specific issues addressed in conjunction with this objective included the following:

- ◆ The elapsed time to resolve all frozen refunds.
- ◆ The elapsed time to resolve frozen refunds that include EITC.
- ◆ The elapsed time to resolve identity theft cases.

**Elapsed Time from Return Filing to Receipt of Refund**

The time from return filing to refund issuance was used to determine the length of time CI froze refunds.<sup>30</sup> Figure 6 depicts the average elapsed time (in weeks) from return filing to refund issuance for all sample case refund recipients and for those sample refund recipients entitled to EITC.

**FIGURE 6: AVERAGE LENGTH OF TIME CI FREEZES REFUNDS****Identity Theft**

In a small subset of the sample cases, the taxpayers were the victims of identity theft.<sup>31</sup> These cases comprised about six percent (27 cases) of the sample. Although not a significant portion of the sample, these cases are of particular concern because the taxpayers whose identities were stolen experienced frozen refunds as a result of someone else's illegal actions. After examining the sample cases, we determined that 25 of the 27 tax-

<sup>30</sup> The length of time that a taxpayer's refund was frozen was computed by subtracting the return posting cycle from the cycle when the refund was actually issued to the taxpayer. The cycle of refund issuance was determined to be the cycle of the latest, unreversed transaction code generating the refund.

<sup>31</sup> Identity theft cases were identified from the DCI's recordation of the manual review of the sample cases.

payees were issued a refund.<sup>32</sup> At 38 weeks, the median time necessary to issue refunds on identity theft cases was similar to that for all refund cases in the sample. During our analysis of the four tax years from 2001 through 2004, we determined that 30 refunds<sup>33</sup> were frozen in tax years after the original freeze. The median time for issuance of refunds on these subsequent tax years was six months.<sup>34</sup>

**Objective IV: Determine the likelihood that taxpayers will become repeat filers of fraudulent returns.**

*Only six percent (29 cases) of the sample cases had indicia of repeat fraud. Moreover, in 25 of the 29 cases, the initial identification of possible fraud was not in time to freeze the refund. Therefore, less than one percent of all taxpayers in the sample were repeat offenders if they had their refunds frozen in a prior year.*

The following component questions of this objective are addressed below:

- ◆ How many taxpayers with prior indicia of fraud file a subsequent refund return with indicia of fraud?
- ◆ How many of the sample cases showed no indication of repeat fraud?
- ◆ What is the effect of the timing of the CI refund freeze?

**How Often Indicia of Fraud Repeat**

Figure 7 displays the probability that a taxpayer will repeatedly submit refund returns indicative of fraud.<sup>35</sup> It illustrates that about 75 percent of the sample cases show no indication of repeat fraud, while only about six percent of the sample cases have indicia of repeat fraud. The presence or absence of repeat fraud in 19 percent of the cases remained undecided, because either a fraud determination had not been made in the sample year or in a year subsequent to the sample year.

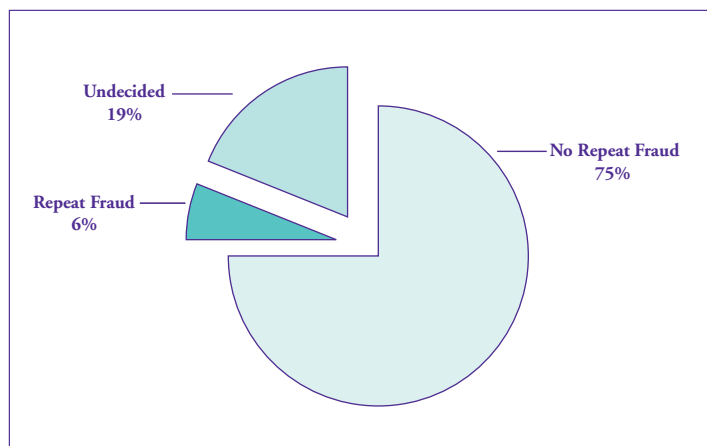
<sup>32</sup> Additional research is required to determine the disposition of the two cases where taxpayers did not receive refunds.

<sup>33</sup> Some taxpayers had refunds frozen more than one additional year.

<sup>34</sup> For a fuller discussion of identity theft issues see Most Serious Problem: *Criminal Investigation Refund Freezes*; and Most Serious Problem: *Identity Theft*, Vol. I.

<sup>35</sup> Analysis is based on 454 of 473 sample cases. Sample year cases for Tax Year 2001 were removed from the analysis because data to determine possible prior fraud was not available. Tax Year 2004 cases in which 2004 was the first year evidencing fraud were also removed from the analysis (Sample data was not available for tax years prior to 2001 or after 2004).

FIGURE 7: INCIDENCE OF PRIOR YEAR FRAUD



### Timing of CI Refund Freeze

The vast majority of the cases with an indication of repeat fraud (25 out of 29 cases) were those where the refund freeze was applied too late to stop the refund from being issued when fraud was first suspected. Accordingly, less than one percent of the sample cases are representative of instances where the taxpayer has demonstrated a willingness to repeat non-compliant behavior after being previously impacted by CI compliance actions.

**Objective V:** Compute the amount of revenue actually protected and compare to interest that is paid on subsequently released refunds.

*When considering all sample cases, more than 80 percent of the refund amounts frozen by CI are ultimately returned to the taxpayer, often with interest.*

The following questions will be addressed in this section:

- ◆ What was the dollar amount of refunds frozen by CI?
- ◆ What was the final amount of refund after CI intervention?
- ◆ What was the amount of revenue protected by the refund freeze?
- ◆ How much interest was paid by the IRS on frozen refunds ultimately released to the taxpayer?
- ◆ What was the outcome of cases input into the Scheme Tracking and Referral System (STARS)?

### Analysis of Refunds and Revenue Protected

TAS Research determined the amount of revenue protected by subtracting the refund actually issued to the taxpayer (based on the net Master File transaction codes for refund issuance and reversal) from the refund amount claimed on the original return (IRS com-

puted amount after return processing).<sup>36</sup>

Figure 8 addresses the first three components of this objective by depicting the aggregate amount of refunds claimed by the taxpayer (IRS computed amounts after processing), the aggregate amount of refunds actually issued and the aggregate net revenue protected for all sample cases. Revenue protected is computed as the difference between the refund claimed on the return (IRS computed amount after processing) and the amount of refund actually issued by the IRS.

**FIGURE 8: NET REVENUE PROTECTED (ALL SAMPLE CASES)**

	Case Volume	Actual Refund <sup>37</sup>	Claimed Refund	Revenue Protected
Non-Outliers	471	\$ 1,101,575	\$ (1,799,523)	\$ 697,948
Large Actual Refund (Outlier 1 – Decided) <sup>38</sup>	1	\$ 1,359,175	\$ (5,051)	\$ (1,354,124)
Large Claimed Refund (Outlier 2 – Undecided)	1	\$ -	\$ (1,231,136)	\$ 1,231,136
Total	473	\$ 2,460,750	\$ (3,035,710)	\$ 574,960

If the outcome of the case was not decided at the time of the Master File data extract, the revenue protected amount was considered to be the entire amount of the claimed refund (IRS computed amount after processing). The net refund includes interest paid to the taxpayer because of the delay in receiving the refund. If the amount of refund issued exceeded the refund claimed on the return (as computed by IRS after processing), the revenue protected amount is a negative number.

Figure 8 includes all 473 sample cases. The table also displays two “outlier” cases separately: one undecided case in which a large refund (over \$1 million) was claimed, and one decided case in which the actual refund exceeded the refund claimed on the original return (IRS computed amount after processing) by over \$1 million. The net amount of revenue protected totals nearly \$575,000. If both outlier cases are removed, the revenue protected would increase to nearly \$700,000.<sup>39</sup> If the undecided case with the refund claimed of over \$1.2 million is determined to be due the taxpayer, however, the net revenue protected will be a negative amount, meaning that the IRS refund freeze will have actually cost the government over \$650,000.<sup>40</sup> Over \$81,000 of interest is included in the final refunds issued to the taxpayers because of the delay in receiving the refund due. Additional interest may also be due taxpayers for the 75 undecided cases.

<sup>36</sup> The amount of revenue actually protected could be overstated, because data on refund offsets was not captured. It is likely that some taxpayers in the sample who were otherwise entitled to a full refund had their refunds reduced by offset.

<sup>37</sup> Includes interest paid by IRS to taxpayer as a result of the delay in refund issuance.

<sup>38</sup> An outlier is an individual observation that stands apart from the usual pattern where the unusual behavior may be attributable to factors other than those being studied. In this instance it represents an original return claiming a modest refund (about \$5,000), which is ultimately awarded a refund in excess of \$1.3 million.

<sup>39</sup> See Non-outlier row in Figure 8.

<sup>40</sup> \$574,960 - \$1,231,136 = -\$656,176.



The average amount of protected revenue for all sample cases is slightly more than \$1,200. This amount is significantly less than the average dollars recommended on returns selected for examination.<sup>41</sup>

**FIGURE 9: NET REVENUE PROTECTED (ALL CASES THAT HAVE BEEN DECIDED)**

	Case Volume	Actual Refund <sup>42</sup>	Claimed Refund	Revenue Protected
Non-Outliers	397	\$ 1,098,134	\$ (1,546,523)	\$ 448,389
Large Actual Refund (Outlier 1 – Decided)	1	\$ 1,359,175	\$ (5,051)	\$ (1,354,124)
Total	398	\$ 2,457,309	\$ (1,551,574)	\$ (905,735)

Unlike the prior analysis which included all 473 cases, Figure 9 uses the same definitions as the previous table but is constructed without the 75 undecided cases. If the return receiving a refund in excess of \$1.3 million is omitted, the revenue protected is about \$450,000. However the inclusion of this return yields a negative amount of revenue protected in excess of \$900,000.

### Analysis of STARS Cases

CI uses the Scheme Tracking and Referral System (STARS) to estimate the amount of revenue protected. When CI determines that a return is fraudulent, after manual review and verification, it places the account in “Z” freeze status and includes the return in the STARS system.

CI appears to have made an initial determination of fraud on 171 of the sample cases. TAS Research identified these cases by finding the earliest instance of a Z freeze and comparing the input cycle of the CI freeze to the return posting cycle. In all 171 cases, the earliest CI freeze occurs on or after the return posting cycle, indicating that the return was frozen based on its characteristics, rather than due to a determination of fraud in a prior year.

Among decided cases (142 out of 171), about 46 percent (65 out of 142 cases) reflect an erroneous determination of fraud by CI, as demonstrated by Figure 10. Although these cases were placed in Z freeze status by CI, the taxpayer ultimately received a full refund.

**FIGURE 10: DETERMINATION OF CASES WHERE MANUAL REVIEW INDICATES FRAUD**

Current Year Status	Cases	Percent
No Current Fraud	65	38.0%
Undecided	29	17.0%
Current Fraud	77	45.0%
Total	171	100.0%

<sup>41</sup> IRS, *FY 2004 Data Book* Table 10. Average dollars recommended for non-business returns with total positive income less than \$25,000 is over \$10,000.

<sup>42</sup> Includes interest paid by IRS to taxpayer as a result of the delay in refund issuance.

TAS Research determined that two of these 65 taxpayers experienced another refund freeze in the following year, despite the fact that the initial fraud determination was erroneous.

#### Objective VI: Determine if CI cases are correctly coded on TAMIS.

*An analysis of the Master File data clearly indicates that the majority of the CI refund cases referred to TAS do ultimately result in the issuance of a full refund. Overall, a review of all sample cases showed that about 90 percent were correctly coded by TAS.*

The following facets of this objective will be analyzed:

- ◆ A comparison of TAS relief coding to the final case resolution.
- ◆ An analysis of TAS accuracy of relief coding.

#### Comparison of TAS Relief Coding to Case Resolution

There is a significant discrepancy between CI and TAS statistics regarding the outcome of CI refund freeze cases. In general, TAS records indicated that the majority of taxpayers received relief (*i.e.*, the refund was released), while CI records indicated that most taxpayers were appropriately denied the claimed refund. While TAS does not have access to CI data regarding the outcome of the frozen refund returns, Master File data supports TAS' contention that most of the frozen refund cases in its inventory do receive a full refund. In fact, as previously indicated, about 56 percent (263 of 473) of the taxpayers in our sample received a full refund. When considering only the decided cases, about two-thirds (263 of 398) of the taxpayers received a full refund. An analysis of the overall TAS coding on the sample cases indicated that the vast majority were coded correctly.<sup>43</sup> Figure 11 compares the TAS coding of relief (if any) provided to the taxpayer to the actual outcome of the case.

**FIGURE 11: ANALYSIS OF TAMIS CODING**

Sample Year Fraud Status / TAMIS Relief Code	No Relief	Full Relief	Partial Relief	Total
No Fraud	37	213	13	263
Undecided	73	2	0	75
Fraud	86	42	7	135
Total	196	257	20	473

Figure 11 compares the TAS coding of relief (if any) provided to the taxpayer to the actual outcome of the case. This figure shows some clear discrepancies (see shaded cells) between the TAS recordation of relief and what actually happened to the case. However, many of these discrepancies are explained by TAS procedures governing the coding of the

<sup>43</sup> This analysis was based on DCI data. Some of the differences in outcomes reported by TAS and CI are likely attributable to instances where a reduced refund amount was ultimately issued. For example, if a taxpayer filed an amended return reducing the refund on a module frozen by CI to the correct amount, this case would be coded as a "full relief" case in accordance with TAMIS coding conventions.

relief provided to the taxpayer. Overall, about 20 percent of the sample cases have coding, which is seemingly inconsistent with the ultimate resolution of the case. Each of the potential categories of discrepancy is discussed below.

#### **No Sample Year Fraud and TAMIS coded “No Relief”**

There were 37 cases where no sample year fraud was detected (full refund was released), but TAS coded the closed case as “no relief.” TAS closed 29 (78 percent) of these cases prior to the release of the refund, and therefore coded them correctly. Of the remaining eight cases, five were coded as “no relief” as a result of the taxpayer not receiving the requested relief even though the refund was released (*e.g.*, frozen refund was released, but offset to another debt, so taxpayer never received refund). The remaining three cases were coded incorrectly on TAMIS.

#### **Sample Year Undecided and TAS Coded “Full Relief”**

Only two cases have these characteristics. TAS reviewed both cases and determined that they were coded incorrectly.

#### **Sample Year Fraud Indication and TAS Coded “Full Relief”**

Of the 42 cases in this category, 20 (48 percent) cases included the input of an amended return. Therefore, the TAS coding is correct, but the return is still considered to have an “indication” of fraud since all of the refund claimed on the original return was not received. The remaining 22 cases (52 percent) were coded incorrectly by TAS.

#### **No Sample Year Fraud and TAS Code “Partial Relief”**

A manual review of these cases shows that eight of the 13 cases (62 percent) were coded correctly by TAS. For the correctly coded cases, the “partial relief” designation is because the taxpayer had come to TAS with other issues (often other tax year refunds which were frozen by CI) which could not be resolved at the time of case closing.

### **CONCLUSIONS**

#### **I. Describe the characteristics of taxpayers coming to TAS because their refunds were frozen by CI.**

Most of the taxpayers in the sample were in the lower income strata, and on the average, the frozen refund represented over 25 percent of their yearly incomes. About 75 percent of the taxpayers in the sample were eligible for the Earned Income Tax Credit.

Nearly all of the cases are referred to TAS by Accounts Management (AM), and this finding has several important implications for the IRS. One, it suggests the important role that AM plays in ensuring that taxpayers who need assistance from TAS are properly directed to TAS. Two, it suggests that opportunities to improve taxpayer awareness of TAS exist within the other organizations responsible for TAS referrals.

The taxpayers in our sample who claimed the EITC were no more likely to have committed fraud than those taxpayers who did not claim the EITC. This finding suggests that taxpayers who claim EITC are no more likely to engage in fraud than taxpayers who do not claim the EITC.

We determined that in six percent of the sample cases, the taxpayers were victims of identity theft.<sup>44</sup> This finding demonstrates another problem that identity theft has created for taxpayers and tax administration, in general.

## II. Determine the number of taxpayer refunds held effectively (in cases of fraud) or ineffectively (in cases where fraud was not substantiated).

We found that nearly two-thirds (66 percent) of the decided cases in our sample were not fraudulent. This is a concern, since TAS had over 28,000 CI related cases in FY 2005 and CI receipts have increased rapidly over the last several years. Moreover, it is likely that at least some portion of taxpayers who have their refunds frozen by CI, but do not seek TAS assistance, also experience significant delays in receiving their refunds.

From FYs 2002-2005, the number of cases referred to TAS as a result of CI actions to deter fraud has grown by over 400 percent. Given our sample results, we are 95 percent confident that between 62 percent and 70 percent of all taxpayers who came to TAS because of CI actions did not commit fraud. Given the FY 2005 case count, this finding suggests that between 17,535 and 19,797 of the taxpayers who came to TAS for assistance with frozen refunds during the fiscal year had not committed fraud.<sup>45</sup> The definition TAS Research used to determine the presence of fraud is very broad. In this study, any reduction in the refund originally claimed by the taxpayer is considered as an indication of fraud. It is likely that in some cases the adjustments to the refund amount resulted from honest taxpayer error. In addition, the refund amount was based solely on the amount actually received by the taxpayer. Data was not obtained to determine those instances in which the originally claimed refund was awarded, but the amount actually received by the taxpayer was reduced because of an offset of part or all of the refund to another tax or obligation collected by the IRS. It is likely that some taxpayers in the sample who were classified as fraudulent actually had their refunds reduced by offset and were not fraudulent.

In almost 18 percent of the sample cases, CI prohibited TAS from contacting the taxpayer in response to the taxpayer's inquiry about the frozen refund. In over 20 percent of these cases the taxpayer ultimately received a full refund. It is possible that more taxpayers would have received a full refund if TAS had been given permission to contact the taxpayer. In light of this finding, TAS believes that CI should reevaluate its policy

<sup>44</sup> There were 27 cases of identity theft out of 473 cases.

<sup>45</sup> 66 percent +/- 4 percent = 62 percent / 70 percent respectively.  $.62 \times 28,282 = 17,535$ ;  $.70 \times 28,282 = 19,797$ .

concerning communication with taxpayers in freeze status.<sup>46</sup>

### III. Determine the length of the CI freeze that holds taxpayer refunds.

Typically, it took about nine months for taxpayers to receive their refunds. The delay is longer for some, as one out of every five taxpayers in this group did not receive their refunds for over a year. TAS is concerned that this delay imposes a severe economic hardship on many taxpayers.

Over one half of the taxpayers in the sample had an adjusted gross income (AGI) below \$13,000, and many ultimately received the EITC. The value of the taxpayers' refunds also represents over 25 percent of the income for the average taxpayer and much more for those with lower incomes. The extended delay undoubtedly forces some of these taxpayers to seek other high cost sources of funds (*e.g.*, high interest payday loans, *etc.*).

TAS believes that additional consideration should be given to funding limitations that exist within CI and Examination. CI is currently not limiting the number of cases in which it freezes refunds to only those that can be processed within a reasonable timeframe.

### IV. Determine the likelihood that taxpayers will become repeat filers of fraudulent returns.

Only six percent of taxpayers in the sample were found to have repeat indicia of fraudulent actions.<sup>47</sup> In over 85 percent of these cases, the CI identification of fraud was too late to stop issuance of the refund in the initial year. This suggests that CI's efforts to prevent future fraud are effective if the compliance action materially affects the taxpayer. This finding also suggests that CI's current policy of freezing future refunds for a certain number of years may be overly restrictive and administratively inefficient.

### V. Compute the amount of revenue actually protected and compare to interest that is paid on subsequently released refunds.

At most, after considering interest paid on delayed refunds, CI protected less than 20 percent of the refund amounts originally frozen.<sup>48</sup> The amount of interest paid to taxpayers who ultimately received their refunds was more than 15 percent of the amount protected. Depending on the outcome of one large undecided case, the amount of revenue protected may actually be negative.

CI uses the STARS system to estimate the amount of revenue protected. When CI determines that a return is fraudulent, after manual review and validation, it places the account in "Z" freeze status and includes the return in the STARS system. Given that among the decided STARS cases in our sample, approximately 46 percent of the tax-

<sup>46</sup> Many of these taxpayers may benefit from knowing the location of the Low Income Taxpayer Clinics (LITCs) that may be able to offer legal assistance.

<sup>47</sup> There were 29 cases out of 454 cases.

<sup>48</sup> 18.9 percent. See Figure 8 (\$574,960 / \$3,035,710).

payers ultimately received full refunds, TAS believes that the CI manual review process should be improved to increase accuracy and reduce taxpayer burden.

**VI. Determine if TAMIS is correctly coding CI cases.**

An analysis of the Master File data clearly indicates that the majority of the CI refund cases referred to TAS do ultimately result in the issuance of a full refund. Overall, a review of all sample cases showed that about 90 percent were correctly coded by TAS.

# FREEZE STUDY

## RECOMMENDATIONS

TAS recommends that CI and the Business Operating Divisions determine the marginal revenue gained by working different categories of returns identified as fraudulent. The marginal revenue gained by working these cases can then be compared to the yield gained in Examination by working non-fraudulent cases to see if the expenditure of resources on some of these cases is merited.

CI should consider alternative treatments for addressing noncompliance among taxpayers suspected of fraud. These alternative treatments may encompass methods similar to those used currently by Examination. For example, a “soft” letter may be an effective tool for addressing noncompliance among taxpayers suspected of fraud, where the dollar amount of the alleged noncompliance is relatively small or there is evidence of a “facilitator” (e.g., a preparer).

In collaboration with the SB/SE and W&I Operating Divisions and TAS, CI should consider conducting a similar research study on a sample of refund freeze cases worked without TAS assistance. Study design presents special challenges, since many taxpayers, especially those in the lower income strata, may not have received refunds they were entitled to because they were unable to effectively pursue their claims. This study, combined with the results herein, would allow the IRS to better assess the effectiveness of CI’s refund freeze program. The IRS should also consider establishing a cross functional team to review the findings and recommendations from both studies. A balanced review will lead to improved program administration and reduced taxpayer burden.

CI should notify taxpayers soon after their refunds are frozen that their refund claims are being reviewed and will not be released until a determination is made. Notification should include complete coverage of taxpayer rights (e.g., their right to file suit in tax court to claim their refunds) and a list of resources available to taxpayers for assistance (e.g., TAS and the Low Income Taxpayer Clinics).

CI should consider using its scoring algorithm to rank cases suspected of fraud. This would enable CI to freeze only those cases that have the highest scores, greatest risk of fraud, and for which the IRS has sufficient resources to ensure timely processing.

CI should review its policy of freezing refunds for a certain number of subsequent tax years after fraud is initially detected. Study findings show that the likelihood of taxpayers repeating fraudulent behavior is very small. Additionally, the resources devoted to these subsequent periods could be better utilized to work new inventory more expeditiously. Also, subsequent returns will be reviewed automatically by CI’s ongoing fraud detection procedures. TAS is concerned that this practice could potentially be harming taxpayers who qualify for a refund by discouraging them from filing (e.g., taxpayers who qualify for the EITC).

# FREEZE STUDY

VOLUME  
**TWO**

CI should consider shortening the 180 day period during which other IRS organizations cannot assist the taxpayer to 60 or 90 days from the date the refund freeze begins. This would help alleviate taxpayer burden by enabling TAS to assist taxpayers much sooner. TAS also recommends that CI develop expedited procedures for certain circumstances, including economic hardship, EITC, and identity theft cases.



## CRIMINAL FRAUD PENALTIES

### BADGES OF FRAUD

Fraud is established by demonstrating that a taxpayer intended to evade a tax that was due and owing by conduct intended to conceal, mislead or otherwise prevent the collection of such tax.<sup>49</sup> Mere negligence is not fraud.<sup>50</sup> Courts have established certain indicia of fraud (often referred to as “badges of fraud”), including:

- ◆ Understating income;
- ◆ Maintaining inadequate records;
- ◆ Giving implausible or inconsistent explanations;
- ◆ Concealing income or assets;
- ◆ Failing to cooperate with tax authorities;
- ◆ Providing incomplete or misleading information to one’s tax preparer; and
- ◆ Filing false documents and dealing primarily in cash.<sup>51</sup>

### Sanctions for Fraud

The federal government has an array of civil and criminal statutes it can employ to punish and deter fraud,<sup>52</sup> including:

- ◆ Civil fraud penalty for fraudulent underpayment of tax of 75 percent of the underpayment;<sup>53</sup>
- ◆ Civil penalty for fraudulent failure to file of 75 percent of the amount required to be shown as tax on the return;<sup>54</sup>
- ◆ Criminal sanctions of imprisonment for up to 3 years and monetary fines of up to \$100,000 (\$500,000 for corporations) for filing false returns, statements or other documents under penalties of perjury with the IRS;<sup>55</sup>

<sup>49</sup> *Clayton v. Comm’r*, 102 T.C. 632, 647 (1994). Neither the Internal Revenue Code nor Treasury Regulations specifically define fraud.

<sup>50</sup> *Mitchell v. Comm’r*, 118 F.2d 308, 310 (5th Cir. 1941) (applying the definition of fraud with respect to the fraud penalty under the predecessor of IRC § 6663). The court stated:  
Negligence, whether slight or great, is not equivalent to the fraud with intent to evade tax named in the statute. The fraud meant is actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing.

<sup>51</sup> *Spies v. U.S.*, 317 U.S. 492, 499 (1943); *Conti v. Comm’r*, 39 F.3d 658, 662 (6th Cir. 1994); *Douge v. Comm’r*, 899 F.2d 164, 168 (2d Cir. 1990); *Bradford v. Comm’r*, 796 F.2d 303, 307 (9th Cir. 1986).

<sup>52</sup> The distinction between civil and criminal punishment for fraudulent conduct under the Internal Revenue Code and other federal statutes relates to the extent of sanctions that can be imposed, the burden of proof and the intended purpose of the sanction. Civil fraud penalties under the Internal Revenue Code are monetary in nature, and the government must establish culpability by clear and convincing evidence. IRC § 7454(a); *see also* Tax Ct. R. 142(b). Under statutes imposing criminal sanctions, punishment can include fines and imprisonment, and the government must prove all elements of the offense by a standard of “beyond a reasonable doubt.” *U.S. v. Boulware*, 384 F.3d 794 (9th Cir. 2004). Criminal sanctions are primarily intended to punish, while civil penalties are intended to draw a distinction between acceptable and unacceptable conduct and to deter unacceptable behavior. *Helvering v. Mitchell*, 303 U.S. 391, 399 (1938); *see also* Jay Soled, *Third Party Civil Tax Penalties and Professional Standards*, 2004 Wis. L. Rev. 1611, 1635 (2004).

<sup>53</sup> IRC § 6663.

<sup>54</sup> IRC § 6651(f).

<sup>55</sup> IRC § 7206.

## CRIMINAL FRAUD PENALTIES

- ◆ Criminal sanctions of imprisonment for up to 5 years and fines for filing false, fictitious or fraudulent claims with any U.S. government agency or office.<sup>56</sup>

The pursuit of civil sanctions in addition to criminal enforcement is essential to maintaining voluntary compliance.<sup>57</sup> By imposing civil and criminal sanctions, the IRS sends a vitally important message to taxpayers that cheating will not be tolerated.

### Burden of Proof in Fraud Cases

Unlike in deficiency cases, where the Commissioner is entitled to the presumption of correctness, the IRS bears the burden of proving civil and criminal fraud. Civil and criminal Federal income tax fraud contain identical elements, but the degree of required proof differs.<sup>58</sup> Criminal conviction of a tax offense requires the Department of Justice to establish each element of the crime beyond a reasonable doubt.<sup>59</sup> A civil fraud case requires the government to prove both the underpayment of tax and fraud by clear and convincing evidence.<sup>60</sup> A criminal conviction for income tax evasion collaterally stops the taxpayer from relitigating the issue in the civil proceedings.<sup>61</sup>

Proof of fraud with intent to evade a tax due and owing may be established either by direct evidence or by indirect or circumstantial evidence. Some of the methods the IRS uses to prove fraud include the so-called “badges of fraud,” the net worth<sup>62</sup> method, the expenditures method,<sup>63</sup> and the bank deposits method.<sup>64</sup>

CI selects “for investigation all information items which, upon evaluation and screening, are deemed to warrant inquiries....”<sup>65</sup> Thus, when the QRP utilizes data mining software to search for returns claiming refunds and containing data elements that CI believes are indicators of fraud, the returns selected then warrant additional inquiries and consequently the refunds are frozen pending investigation. The initial investigation “should involve such inspection of the taxpayer’s books and records or other related inquiries as is necessary to initially determine whether the case possesses criminal potential.”<sup>66</sup>

<sup>56</sup> 18 U.S.C. § 287.

<sup>57</sup> Treasury Inspector General for Tax Administration, Ref. No. 2004-10-189, *Improvements Are Needed to Ensure Information Developed During Criminal Investigations is Referred for Civil Action* 1 (Sept. 2004).

<sup>58</sup> The Tax Division of the Department of Justice prosecutes criminal tax fraud cases following referral from the IRS and defends the IRS in civil tax fraud cases in the district courts and Court of Federal Claims. The IRS Office of Chief Counsel defends civil tax fraud cases in the Tax Court.

<sup>59</sup> *Holland v. U.S.*, 348 U.S. 121, 126 (1954); IRM § 9.5.1.2.2(1).

<sup>60</sup> IRC § 7454(a); Tax Ct. R. 142(b).

<sup>61</sup> *Arctic Ice Cream Co. v. Comm’r*, 43 T.C. 68, 74-75 (1964), *acq.*, 1966-2 C.B. 4.

<sup>62</sup> Unexplained deposits or acquired property (increases in net worth) in excess of reported income and cash reserves are considered the equivalent of unreported income. See IRM § 9.5.9.5.1.1 for a discussion of the legal requirements to establish a prima facie net worth investigation.

<sup>63</sup> If a taxpayer’s expenditures during a given period exceed his/her reported income and the source of the funds used to make those expenditures is unexplained, the IRS may infer that such expenditures represent unreported income. See IRM § 9.5.9.6.

<sup>64</sup> In some circumstances, proof of deposits can be substantial evidence of income. See *Gleckman v. U.S.*, 80 F.2d 394, 399 (8th Cir. 1935); IRM § 9.5.9.7.

<sup>65</sup> IRM § 9.5.1.3.1(1).

<sup>66</sup> IRM § 9.5.1.3.2(1). The focus of the investigation is ascertaining the authenticity of the return and supporting documents and the responsibility of the filer. See IRM § 9.5.3.2.4(1).

If the government is unable to sustain the greater burden of proof in criminal cases of guilt beyond a reasonable doubt, it still may be able to proceed to prove the taxpayer's civil fraud by the lesser "clear and convincing" standard. Once CI has completed its criminal investigation, any information gathered during the administrative criminal investigation can be used to prove the taxpayer's civil fraud.<sup>67</sup>

<sup>67</sup> IRM § 9.5.14.3.1(1). However, there are limitations on using information developed during the course of a grand jury investigation for civil purposes.

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## CI DATA COLLECTION INSTRUMENT (DCI)

### 2005 CI FDC FREEZES CASE REVIEW

2

APPENDIX

APPENDICES

SEID of case reviewer: \_\_\_\_\_

1. FDC Campus ID # \_\_\_\_\_ 2. Primary TP SSN: \_\_\_\_\_ - \_\_\_\_\_ - \_\_\_\_\_

3. DLN: \_\_\_\_\_ - \_\_\_\_\_ - \_\_\_\_\_ - \_\_\_\_\_

#### Tax Return Information

4. Tax year: \_\_\_\_\_ 5. Amount of frozen refund: \$ \_\_\_\_\_

6. Is this case a Questionable Refund Program (QRP) or Refund Preparer Program (RPP) case?

☐ QRP

☐ RPP

☐ Other

7. Why was account frozen? Please indicate all known facts that support freezing the account:

\_\_\_\_\_  
\_\_\_\_\_

8. What is the scheme number (if none, leave blank)? \_\_\_\_\_

#### P Freeze Section

If this account had both a P and a Z freeze, please provide the information on both freezes in the appropriate section.

9. Is this a P freeze case? ☐ Yes ☐ No TXMOD (TC 841)

10. P Freeze Date: \_\_\_\_\_ TXMOD (TC 841 date)

11. Was the P freeze released from the account? ☐ Yes ☐ No TXMOD (TC 290 Date above TC 846 showing refund released)

12. Date of P freeze release: \_\_\_\_\_ TXMOD (TC 290 Date above TC 846 showing refund released) (leave blank if not released)

13. Date refund released (date of TC 846, TC840): \_\_\_\_\_ TXMOD - (leave blank if refund not released)

#### Z Freeze Section

14. Is this a Z freeze case? ☐ Yes ☐ No ENMOD (TC 914/916/918)

15. Z Freeze Transaction Code used to freeze refund: ☐ 914 ☐ 916 ☐ 918 ENMOD (TC 914/916/918)

16. Z Freeze Cycle Date: \_\_\_\_\_ ENMOD (TC 914/916/918)

17. Was a contact letter issued by CI in response to a refund inquiry? ☐ Yes ☐ No

If yes, letter # (if none, leave blank) \_\_\_\_\_

18. If answer to #17 is "yes," date contact letter was issued to taxpayer: \_\_\_\_\_

19. Was Z freeze released from account? ☐ Yes ☐ No TXMOD/ENMOD: Date of TC 915, 917, or 919

20. Date Z freeze was released: \_\_\_\_\_ TXMOD/ENMOD: Date of TC 915, 917, or 919 (if not released, leave blank)

VOLUME  
TWO

## CI DATA COLLECTION INSTRUMENT (DCI)

## Interaction with TAS:

21. Did CI receive an OAR from TAS? ☐ Yes ☐ No
22. Date CI received OAR from TAS, if applicable: \_\_\_\_\_
23. Date CI acknowledged receipt of TAS OAR: \_\_\_\_\_
24. Did TAS misroute this case to the wrong FDC? ☐ Yes ☐ No
25. Did CI confirm with TAS that there was to be “no contact” with this taxpayer? ☐ Yes ☐ No
26. Date “no contact” confirmed by CI, if applicable: \_\_\_\_\_

## Outcome

27. CI Activity Code for this case: \_\_\_\_\_
28. For cases worked to completion by CI, was taxpayer given full relief, partial relief or no relief?  
☐ full ☐ partial ☐ none
29. In cases of full relief, was this a “good” return frozen because the taxpayer filed a fraudulent return in prior years?  
☐ Yes ☐ No
30. In cases of partial or no relief, what element of fraud was captured, if any (check all that apply)?
- |   |   |
|---|---|
| <input type="checkbox"/> Dependents did not qualify               | <input type="checkbox"/> Dependents did not exist         |
| <input type="checkbox"/> Wages inflated                           | <input type="checkbox"/> Wages non-existent               |
| <input type="checkbox"/> Withholding overstated                   | <input type="checkbox"/> Sch C and/or F Income overstated |
| <input type="checkbox"/> Household Help Income (HSH) non-existent | <input type="checkbox"/> Schedule A Deductions overstated |
| <input type="checkbox"/> Other (specify) _____                    |   |
31. In cases of partial relief, was there good income included with false income? ☐ Yes ☐ No
32. In cases of partial relief, was there good withholding included with false withholding? ☐ Yes ☐ No
33. If CI did NOT work this case to completion, was it referred to Exam? ☐ Yes ☐ No
34. Date CI referred case to Exam, if applicable: \_\_\_\_\_
35. If case was referred to Exam, was Letter 86-C, Referring Taxpayer Inquiry/Forms to Another Office, issued to taxpayer?  
☐ Yes ☐ No
36. Date that Letter 86-C was issued to taxpayer, if applicable: \_\_\_\_\_
37. To which Exam campus was the case referred?
- |                                  |                                      |                                  |                                     |                                       |
|----------------------------------|--------------------------------------|----------------------------------|-------------------------------------|---------------------------------------|
| <input type="checkbox"/> Andover | <input type="checkbox"/> Atlanta     | <input type="checkbox"/> Austin  | <input type="checkbox"/> Brookhaven | <input type="checkbox"/> Cincinnati   |
| <input type="checkbox"/> Fresno  | <input type="checkbox"/> Kansas City | <input type="checkbox"/> Memphis | <input type="checkbox"/> Ogden      | <input type="checkbox"/> Philadelphia |
38. Please indicate whether any facts are present to suggest fraud exists (check all of the following that apply to this tax year):
- |   |  |   |
|---|--|---|
| <input type="checkbox"/> Fraud            | <input type="checkbox"/> No Fraud              | <input type="checkbox"/> No Fraud – Stolen Identity |
| <input type="checkbox"/> Prior Year Fraud | <input type="checkbox"/> Can't Determine Fraud |   |

THANK YOU!

## TAS DATA COLLECTION INSTRUMENT (DCI)

### 2005 CI FDC FREEZES MSP TAMIS CASE REVIEW

Reviewer SEID: \_\_\_\_\_

1. **TAS Campus ID#** \_\_\_\_\_

Form 911H

2. **BOD:** \_\_\_\_\_

TXMOD (top right second line)

3. **SSN:** \_\_\_\_\_ - \_\_\_\_\_ - \_\_\_\_\_

Form 911H

4. **TAMIS Case #** \_\_\_\_\_

Form 911H

☐ Check this box if taxpayer on TAMIS history is same taxpayer as on TXMOD and IDRS research. Check SSN.

#### Preliminary Return Data

5. **Tax year:** \_\_\_\_\_

Form 911H – Gather data for the year listed on the F911H. If more than one year is listed, gather data for most recent year.

6. **Was return filed under SSN or ITIN?** ☐ SSN ☐ TIN

TXMOD- If ITIN, TIN will begin with "9" and have either a "7" or "8" in the fourth digit.

7. **Amount of claimed refund frozen (whether by P or Z freeze):** \$ \_\_\_\_\_

TXMOD (not including interest)

8. **If partial refund was released, amount of partial refund:** \$ \_\_\_\_\_

TXMOD (not including interest)

#### TAMIS DATA (from Form 911H)

9. **Who contacted TAS?** ☐ Taxpayer ☐ Preparer ☐ AM – Toll Free  
☐ POA ☐ Congressional Office ☐ Other (specify) \_\_\_\_\_

10. **Was an OAR issued to CI?** ☐ Yes ☐ No

11. **Did TAS misroute this case to the wrong FDC?** ☐ Yes ☐ No

12. **If "yes," date OAR rejected:** \_\_\_\_\_

13. **Date OAR sent to correct FDC:** \_\_\_\_\_

14. **Date correct FDC acknowledged receipt of OAR, if determinable:** \_\_\_\_\_

15. **Is this a multiple year case?** ☐ Yes ☐ No

16. **If taxpayer contacted TAS for multiple years at one time, how many years are involved?** \_\_\_\_\_

17. **If able to determine, is this case a QRP, RRP case, or other?** ☐ QRP ☐ RRP ☐ Other

Form 911H (Also, look for project code on TXMOD.)

## TAS DATA COLLECTION INSTRUMENT

18. Did CI confirm “no contact” with this taxpayer? ☐ Yes ☐ No  
☐ N/A if P freeze is only freeze on account ☐ FDC never responded to OAR(s)
19. Did CI ask TAS to secure verification of tax return information from taxpayer? ☐ Yes ☐ No
20. Did TAS ask taxpayer to provide verification of tax return information? ☐ Yes ☐ No
21. Did the taxpayer provide the requested information? ☐ All ☐ Some ☐ None
22. Did the taxpayer amend the return before coming to TAS? ☐ Yes ☐ No
23. Did the taxpayer amend the return after coming to TAS? ☐ Yes ☐ No
24. If the taxpayer amended the return before or after coming to TAS,  
 did TAS assist taxpayer with preparing or processing the amended return? ☐ Yes ☐ No  
 (Assistance with “preparing” the return includes providing the taxpayer with IRP information and/or assisting with getting a filed amended return processed  
 by the operating division.)
25. Was the refund released as the result of the amended return? ☐ Yes ☐ No
26. Did taxpayer claim that original return shown on module was  
 a fraudulent return filed by someone using the taxpayer’s SSN? ☐ Yes ☐ No
27. Did taxpayer claim that the return shown on the module as an  
 amended return is his or her original filed return and is the correct return? ☐ Yes ☐ No
28. Did CI or Exam, if applicable, determine that the “amended” return is the taxpayer’s original filed return and that the  
 first return shown on the module was not the taxpayer’s return? ☐ Yes ☐ No
29. If “yes” to above, was a refund released to the wrong taxpayer? ☐ Yes ☐ No
30. Date of refund released to wrong taxpayer: \_\_\_\_\_
31. Amount of refund released to wrong taxpayer: \$\_\_\_\_\_
32. Amount of interest included in refund to wrong taxpayer: \$\_\_\_\_\_

## TAS Case Action-Examination Involved—Complete ONLY for cases with Exam

33. Examination Disposal Code: \_\_\_\_\_ TXMOD/IMFOLT (After TC 300/Same cycle)
34. Date Exam case forwarded to Appeals, if applicable: \_\_\_\_\_ TXMOD
35. Date all Exam, Appeals, Court actions completed on case: \_\_\_\_\_ TXMOD (TC 300/421 date)

## Outcome Summary:

36. Total amount of income tax assessed: \$ \_\_\_\_\_  
 TXMODA – Total of TC 150 amount plus TC 290 and/or 300 amounts. Complete even if unchanged.
37. Amount of SE tax increase: \$ \_\_\_\_\_  
 TXMODA (ABST-NUM 889/ABST-NUM, after TC 290)) – leave blank if none



Taxpayer's Last Name \_\_\_\_\_

38. Amount of SE tax decrease: \$ \_\_\_\_\_

TXMODA (ABST-NUM 889- /ABST-AMT, after TC 290) - (leave blank if none)

39. Was taxpayer given full relief, partial relief, or no relief? ☐ Full ☐ Partial ☐ None

Full relief is defined as getting the taxpayer the full refund shown on the original filed return.

40. TAMIS Relief Code: \_\_\_\_\_

41. Is the TAMIS relief code correct? ☐ Yes ☐ No

42. If the TAMIS relief code is NOT correct, what is the correct relief code: \_\_\_\_

43. If full relief, was this a "good" return frozen because the taxpayer filed a fraudulent return in prior years? ☐ Yes ☐ No

(See prior years' IMFOLTS. Consider returns "good" if no adjustments were made.)

44. Was the taxpayer's return subsequently selected for examination? ☐ Yes ☐ No45. If taxpayer's return was subsequently examined, was it determined that taxpayer was entitled to the prior relief, if any, received from TAS? ☐ Yes ☐ No ☐ Exam still open46. Is this a wage verification and/or withholding case only? ☐ Yes ☐ No47. If this was a wage verification case only, did all withholding verify? ☐ Yes ☐ No48. If this was a wage verification case only, did all wages verify? ☐ Yes ☐ No

49. In cases of partial relief or no relief, what element of potential fraud was captured (check all that apply)?

☐ Dependents did not qualify☐ Dependents did not exist☐ Wages inflated☐ Wages non-existent☐ Withholding overstated☐ Sch C and/or F Income overstated☐ Household (HSH) income non-existent☐ Schedule A deductions overstated☐ Other (specify) \_\_\_\_\_

50. Reason TAS case closed (check all that apply):

☐ No reply/hardship not validated☐ No reply/wages/withholding not validated☐ Documents not acceptable☐ CI Determination☐ Exam Determination☐ Appeals Determination☐ Court Determination☐ Taxpayer Withdrew Case☐ Other Reason for closing: \_\_\_\_\_

51. Comments: \_\_\_\_\_

\_\_\_\_\_  
\_\_\_\_\_

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